MDS Health Group Limited

ANNUAL REPORT 1975

MDS HEALTH GROUP

The Year in Review

	1975	1974	Percentage Increase
Revenues	$20,158,000	$15,753,000	28.0
Depreciation	354,000	237,000	49.4
Income Taxes	1,005,000	840,000	19.6
Net Income (Before Extraordinary Item)	1,006,000	805,000	25.0
Net Earnings Per Share (Before Extraordinary Item)	$ .46	$ .37	24.3
Total Assets Employed	11,469,000	9,769,000	17.4
Shareholders' Equity	5,616,000	4,621,000	21.5

Report to Shareholders

Fiscal 1975 was another eventful year for your Company.

Gross revenues reached $20,158,000, an increase of 28% over 1974, and net income before extraordinary item was up 25% to $1,006,000. Per share earnings before extraordinary item increased to 46¢ per share from 37¢ per share in 1974.

In addition to the improved financial results, 1975 was a year of business evaluation and consolidation and resulted in the decision to focus future efforts on the Company's area of proven expertise . . . . the provision of services to health professionals. MDS enjoys a very close relationship with health professionals due in large part to the advice and counsel of its Medical Advisory Board and during 1975, this concept was expanded by the formation of individual Medical Advisory Committees for all operating divisions.

This decision also resulted in the sale of the assets and business of the company's generic pharmaceutical manufacturing and distribution business in November 1975, for a fiscal 1976 net extraordinary gain of $50,000. Development work is continuing on one of the new drugs, "Glyptide" and it is expected clinical trials will be completed in mid-1976. At the moment the Company is considering various alternative methods of marketing the new drugs, including a joint venture with an established pharmaceutical marketing organization. Investigation of other new drug products has been temporarily terminated pending the result of the Glyptide clinical trials.

By far the largest operating segment of MDS continues to be the clinical laboratory division which now services over 100,000 patients per month. The majority of the Company's capital investment and efforts have been concentrated in this area and over a two year span nearly $2,000,000 will have been spent on new and upgraded laboratory facilities and equipment, a program that was substantially completed by the end of fiscal 1975. This expenditure on facilities and equipment has enabled us to effect new and more efficient methods of handling our increased volume of laboratory tests and help offset the rapidly increasing costs for technologists' salaries and materials of the past few years. As we enter 1976, average laboratory salaries have increased by 80% since 1971, whereas average unit fees payable under the Ontario Health Insurance Plan have increased only 4%.

On May 1, 1974 a new OHIP fee schedule was introduced which was to provide equivalent revenues to the schedule in effect before that date. However, the new payment resulted in a decrease in fees of 8% which reduced earnings in the first half of fiscal 1975. Although no retroactive adjustment was made for lost revenues, on May 1, 1975 the fees were adjusted by the 8% to regain equivalence plus an additional 4% which helped offset some of the increased labour and material costs and coupled with improved efficiency, allowed the decreased margins to return to more acceptable levels.

Fiscal 1975 saw MDS Professional Services Limited complete seven medical buildings and establish a base for continued growth in 1976. Considering the uncertain economic conditions of the past year and the high interest rates, the progress in "Prof" has been satisfactory.

The Health Care Services Division continued its growth in 1975 with revenues up 31% over 1974. During the year, the emphasis for future concentration of the Health Care Services Division was expanded to include the provision of "Occupational Health" services to business and industry.

MDS looks to a substantial expansion of the range and volume of industrial services in fiscal 1976 and in January, 1976 made arrangements to acquire the Evans Industrial Clinic which is located in New Toronto and provides first aid, accident and pre-employment medical services for a number of industries in the area. The acquisition is contingent upon receiving the necessary approvals and licences.

Substantial changes in product offering and personnel were made in the laboratory supply business in 1975. Otto C. Watzka, the Quebec based laboratory supply operation, finished the year on a sound financial basis and we are looking to improved profitability and revenues in 1976 based on the changes effected in 1975. In addition, OCW Diagnostics commenced the marketing across Canada of a line of specialized diagnostic products late in the fiscal year which will have an impact on revenues in 1976.

The Company is continuing to expend funds on research activities in the field of laboratory medicine. In addition to a continuous program of development work on the refinement of existing methods of performing laboratory procedures, MDS is involved in two areas of more fundamental research involving National Research Council grants approximately $268,000 if continued to completion. If successful, these projects could provide longer term products for the laboratory supply division in addition to improved laboratory efficiency.

Subsequent to the 1975 year-end and as a result of an offer to all shareholders, the Company purchased 400,772 of its own shares at $2.20 per share. The Company also acquired 81,447 shares of a former employee at a price of $2.00 per share. Since the shares were purchased for cancellation, these transactions had the net effect of reducing the outstanding number of shares to 1,669,533 and the common shares authorized to 3,267,781. The Company evaluated other investment opportunities before acquiring its own shares and concluded that this was the best alternative in terms of return on investment and improvement in earnings per share for the shareholders.

In December 1975, the Board accepted the resignation of J. F. McElroy and appointed R. M. Warren as his replacement in January 1976. Mr. Warren is Chief General Manager of the Toronto Transit Commission and has a broad experience in management and public service which makes him a welcome addition to the Board.

With over 900 employees, MDS falls under the Federal Government's new wage and price guidelines. Until these guidelines become clarified, it is impossible to estimate their full impact on the Company.

It is a pleasure to express, on behalf of the Board of Directors, sincere appreciation to employees, consultants, shareholders and users of our services for their continuing support during 1975.

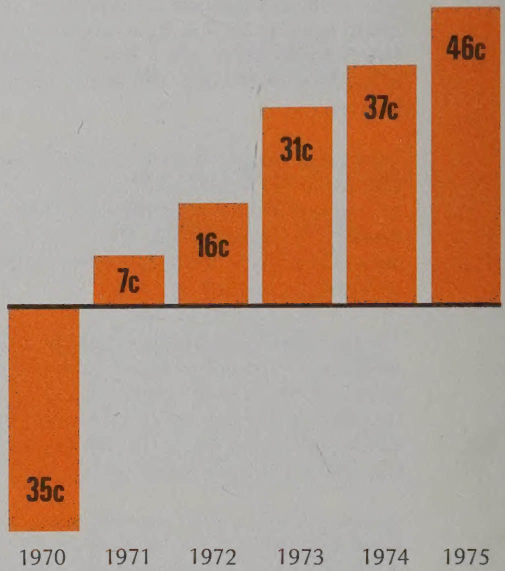
January 28, 1976

On behalf of the Board,

W. G. Lewitt
President

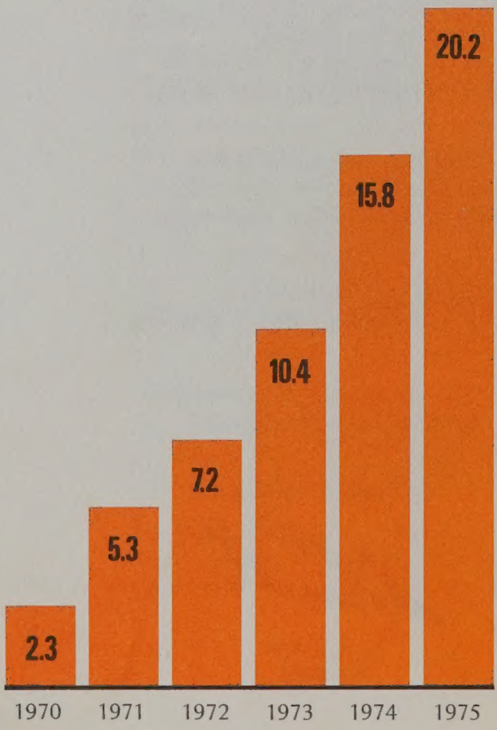
Six Years of Growth

Earnings per Common Share†

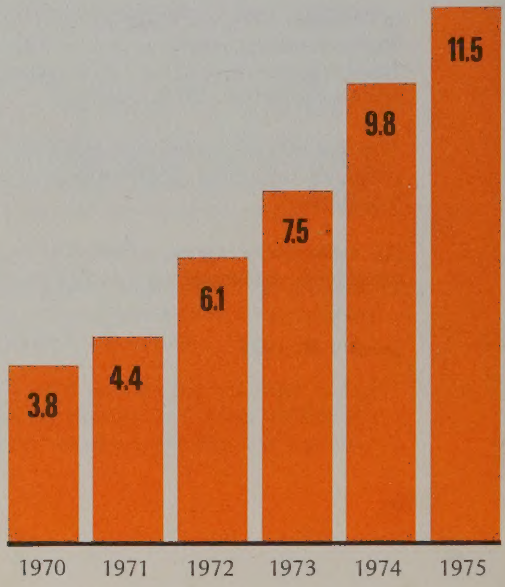


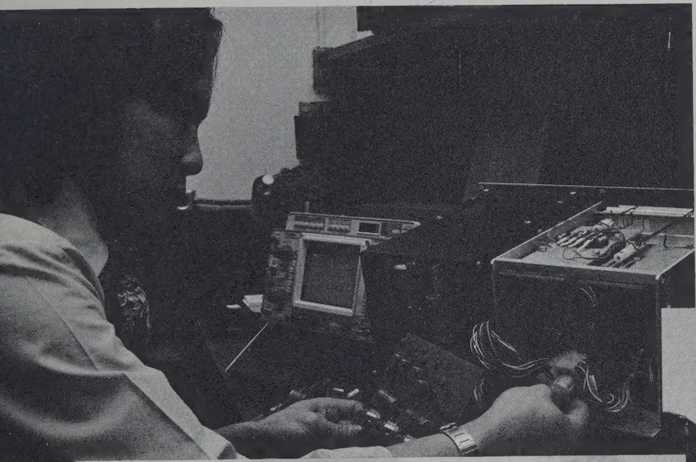
† Before extraordinary items

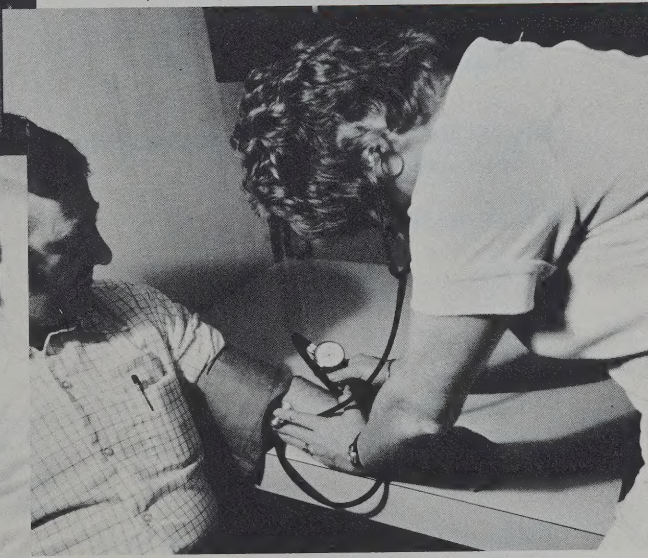
Revenues in Millions

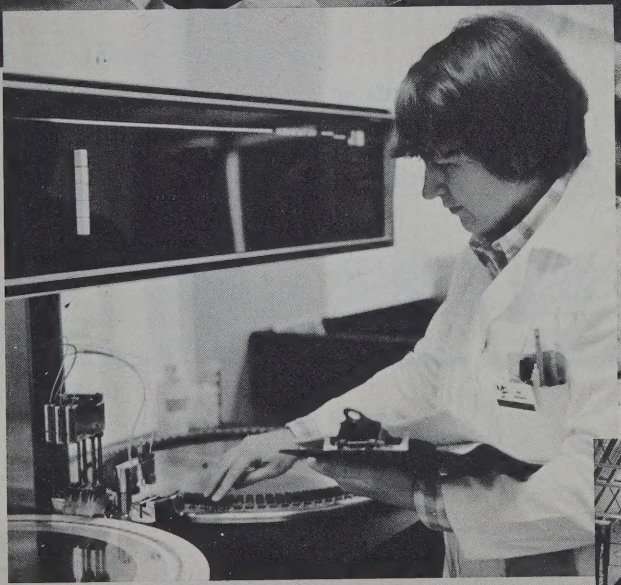


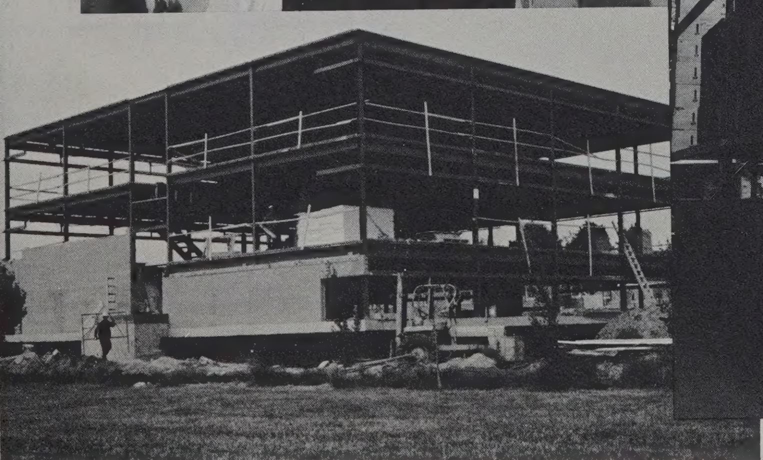
Total Assets in Millions











Consolidated Balance Sheet

October 31, 1975 (with comparative figures as at October 31, 1974)

Assets

	Cost	Accumulated depreciation and amortization	1975	1974
CURRENT ASSETS:				
Accounts receivable (note 2)			$ 3,849,438	$3,164,206
Inventory, at lower of cost and net realizable value			1,002,476	836,682
Investments in shares of and advances to other companies, at cost			469,816	
Future income tax reductions			148,671	334,900
Prepaid expenses			213,895	87,953
			5,684,296	4,423,741
INVESTMENT in shares of and advances to other companies, at cost			157,415	120,986
FIXED ASSETS:				
Land				20,000
Buildings				51,459
Equipment and furniture	$2,326,887	$ 846,603	1,480,284	1,298,158
Leasehold improvements	1,202,623	543,867	658,756	358,512
	$3,529,510	$1,390,470	2,139,040	1,728,129
Excess of amounts paid over the fair value of the net tangible assets acquired on the purchase of shares and assets, less amortization and write off			3,447,618	3,449,718
Premises and equipment deposits			40,640	46,855
			$11,469,009	$9,769,429

(See accompanying notes)

Liabilities and Shareholders' Equity

	1975	1974
CURRENT LIABILITIES:		
Bank indebtedness (note 2)	$ 1,697,062	$1,510,256
Accounts payable and accrued liabilities	1,370,678	1,219,857
Current portion of long term debt (note 2)	145,000	128,500
Income and other taxes payable	868,481	335,770
	4,081,221	3,194,383
LONG TERM DEBT (note 2)	1,701,500	1,845,660
DEFERRED INCOME TAXES	12,000	49,000
MINORITY INTEREST	58,227	59,715
SHAREHOLDERS' EQUITY:		
Capital stock (note 3 and 8 (c))		
Authorized:		
387,000 8% convertible, cumulative preference shares, redeemable at a par value of $5 per share		
3,750,000 common shares without par value		
Issued:		
42,046 preference shares	210,230	210,230
2,151,752 common shares (2,146,752 in 1974)	3,711,072	3,704,822
Retained earnings	1,694,759	705,619
	5,616,061	4,620,671
	$11,469,009	$9,769,429

On behalf of the Board:

W. G. Lewitt, Director

R. H. Yamada, Director

To the Shareholders of MDS Health Group Limited:

We have examined the consolidated balance sheet of MDS Health Group Limited and its subsidiaries as at October 31, 1975 and the consolidated statements of income, retained earnings and changes in financial position for the year then ended. Our examination included a general review of the accounting procedures and such tests of accounting records and other supporting evidence as we considered necessary in the circumstances.

In our opinion these financial statements present fairly the consolidated financial position of the companies as at October 31, 1975 and the results of their operations and the changes in their financial position for the year then ended, in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Toronto, Canada,
January 19, 1976.

CLARKSON, GORDON & CO.
Chartered Accountants

Consolidated Statement of Income

Year ended October 31, 1975 (with comparative figures for 1974)

	1975	1974
Gross revenues	$20,157,515	$15,752,953
Less discounts	1,511,990	1,176,886
Net revenues	$18,645,525	$14,576,067
Operating costs before the following	15,960,733	12,444,803
Depreciation and amortization	353,775	236,567
Interest expense — long term debt	179,363	197,438
— other	142,184	60,617
	$16,636,055	$12,939,425
Operating income	$ 2,009,470	$ 1,636,642
Interest income		32,571
Income before income taxes, minority interest and extraordinary item	2,009,470	1,669,213
Provision for income taxes	1,005,000	840,000
Income before minority interest and extraordinary item	1,004,470	829,213
Minority interest	1,488	(24,452)
Income before extraordinary item	$ 1,005,958	$ 804,761
Extraordinary item:		
Write off of pharmaceutical division acquisition costs		(402,209)
Net income for the year	$ 1,005,958	$ 402,552
Earnings per common share:		
Before extraordinary item	$0.46	$0.37
For the year	$0.46	$0.18

Consolidated Statement of Retained Earnings

Year ended October 31, 1975 (with comparative figures for 1974)

	1975	1974
Retained earnings, beginning of year	$ 705,619	$ 319,885
Net income for the year	1,005,958	402,552
Dividends paid on preference shares	(16,818)	(16,818)
Retained earnings, end of year	$ 1,694,759	$ 705,619

(See accompanying notes)

Consolidated Statement of Changes in Financial Position

Year ended October 31, 1975 (with comparative figures for 1974)

	1975	1974
Funds were provided from:		
Operations —		
Income before extraordinary item and minority interest	$ 1,004,470	$ 829,213
Add charges not requiring an outlay of working capital:		
Depreciation and amortization	353,775	236,567
Deferred income taxes	(37,000)	49,000
Funds provided from operations	$ 1,321,245	$ 1,114,780
Proceeds on sale of fixed assets	91,274	
Long term debt of acquired company		425,000
Issue common shares	6,250	999
Decrease other assets		113,241
Total source of funds	$ 1,418,769	$ 1,654,020
Funds were applied to:		
Purchase fixed assets	853,860	987,326
Reduce long term debt over one year	144,160	203,500
Pay dividends on preference shares	16,818	16,818
Increase other assets	30,214	
	$ 1,045,052	$ 1,207,644
Invest in subsidiaries and divisions —		
Purchase divisions and subsidiaries, less working capital and fixed assets acquired		430,674
Less portion of purchase prices satisfied with the issue of long term debt		(80,000)
		350,674
Total application of funds	$ 1,045,052	$ 1,558,318
Increase in working capital	373,717	95,702
Working capital, beginning of year	1,229,358	1,133,656
Working capital, end of year	$ 1,603,075	$ 1,229,358
Represented by:		
Current assets	$ 5,684,296	$ 4,423,741
Current liabilities	4,081,221	3,194,383
	$ 1,603,075	$ 1,229,358

(See accompanying notes)

Notes to Consolidated Financial Statements

Year ended October 31, 1975

1. Accounting Policies

The following is a summary of certain significant accounting policies followed in the preparation of the consolidated financial statements. The policies conform to generally accepted accounting principles and have been applied consistently.

(a) Basis of consolidation
The accounts of all subsidiaries are consolidated on a purchase basis from the date of acquisition.

(b) Fixed assets
Depreciation is provided on a straight line basis over the estimated useful life of the property. Leasehold improvements are amortized over the lesser of ten years or the length of the lease plus one renewal option.

(c) Development and start up costs
Costs associated with development of new products and locations and with the acquisition of new business are expensed as incurred.

(d) Amortization of intangibles
For acquisitions after March 31, 1974, the excess of amounts paid over the fair value of the net tangible assets acquired on the purchase of shares and assets is being amortized over forty years. For acquisitions prior to April 1, 1974 no amounts are being amortized.

(e) Investments
It is not the company's intention to make long term investments in building projects in which it may be involved. The company's investments are classified as non-current assets, except where there is a reasonable expectation of realization within the next fiscal year.

(f) Income taxes
The company follows the deferral method of income tax allocation. Deferred income taxes result from claiming deductions for tax purposes (principally depreciation and amortization) in excess of amounts charged in the accounts. Under this method, where the company is virtually certain of realizing a future income tax reduction from a loss-carry forward for tax purposes, the future income tax reduction is recognized in the accounts in the current year.

2. Long Term Debt

	1975	1974
Bank term loans	$1,120,000	$ 440,000
Bank term loan *	325,000	325,000
7¼% to 10% notes due up to January, 1979	201,500	210,000
Non-interest bearing note, due September 15, 1983 *	100,000	100,000
8% debenture, due October 2, 1998 *	100,000	100,000
Debt outstanding 1974, refinanced in 1975	—	799,160
	$1,846,500	$1,974,160
Less portion included in current liabilities	145,000	128,500
	$1,701,500	$1,845,660

*debt of subsidiary companies

The principal amounts remaining to be paid in the next five fiscal years are:

Fiscal years ended October, 1976	$ 145,000
1977	606,500
1978	294,000
1979	264,000
1980	208,000
	$1,517,500

The bank term loans, represented by demand promissory notes, bear interest at rates from the prime rate to 2% over the prime rate. Accounts receivable and a floating charge debenture issued by a subsidiary company have been assigned as security. The amounts of loans not expected to be repaid within the next fiscal year are included in long term debt. In addition to the usual conditions the company has agreed to maintain working capital of $250,000 which is defined to exclude debt incurred on the purchase of businesses that is more than 90 days from maturity. Reference also should be made to note 8(b).

3. Capital Stock

(a) Issue of common shares
During the year 5,000 common shares were issued for a total consideration of $6,250 on the exercise of an employee stock option.

(b) Employee stock option plan
Under the employee stock option plan, 67,767 unissued common shares of the company are reserved as at October 31, 1975.

During the year options to purchase 5,000 shares were issued, options to purchase 8,150 shares expired, and options to purchase 5,000 shares were exercised. As at October 31, 1975, 61,884

options were outstanding, 56,884 at $1.25 per share and 5,000 at $1.60 per share. These options are exercisable at various dates up to January 2, 1979.

(c) Other rights to acquire common shares
   (i) As part of a bank loan agreement the company issued warrants to the bank to purchase 14,400 common shares at $5 per share exercisable on or before January 30, 1978.
   (ii) Preference shares may be converted at any time on a one-for-one basis into common shares.

(d) Dividend restrictions
Dividends on the common shares may only be paid with the approval of the bank.

(e) Earnings per common share
Fully diluted earnings per common share approximate basic earnings per common share for both 1975 and 1974.

(f) Reference also should be made to note 8(c).

4. Statutory information

The aggregate remuneration of directors and senior officers (as defined in the Ontario Business Corporations Act) was $345,000 in 1975 ($282,000 in 1974). Included in 1975 is an amount of $19,200 for directors' fees (no fees were paid in 1974) and an amount of $45,000 paid to certain directors for consulting services rendered to the company ($14,000 in 1974).
At a shareholders' meeting on March 18, 1975, a number of internal reorganizations were approved, the most important result of which was to limit the parent company's active business to financial and management services.

5. Commitments

Under the premise and equipment leases entered into by the company and its subsidiaries up to October 31, 1975, the companies are obliged to make minimum payments of approximately $885,000 in 1976, $774,000 in 1977, $577,000 in 1978, $458,000 in 1979, $253,000 in 1980, and $149,000 in total over the period 1981 to 1985.

6. Contingent liabilities

In 1970 the company experienced costs in connection with an AGA laboratory machine that could not be brought to a satisfactory operational level. The related costs and estimated costs were reflected in that year as an extraordinary item in the consolidated statement of loss. The company has commenced a legal suit to recover specific costs of $351,861 and general damages of $100,000. A counter claim of $468,277 has been entered in this action. Counsel have advised that the company has a strong defense to the counter claim.

A partially-owned subsidiary has guaranteed bank loans totalling $250,000 which are secured by the assets to which they relate.

7. Anti-Inflation Act

The company is subject to the mandatory controls of the Anti-Inflation Act, since there are more than 500 employees. It is too early to determine the effect of these controls on the company.

8. Subsequent events

(a) Sale of Pharmaceutical Division
On November 17, 1975, the company sold the generic pharmaceutical division of a subsidiary company for a total consideration of $395,000, $200,000 in cash and $195,000 in a 5-year debenture bearing interest at the bank prime rate plus 2½% (with quarterly repayments of principal and interest). Of the sale price $190,000 related to inventory, $100,000 to fixed assets and $105,000 to goodwill. It is estimated that the after tax gain on the sale after taking into consideration all the costs of the transaction will be $50,000.

(b) Bank refinancing
Subsequent to the year end the company negotiated increased financing with a Canadian chartered bank. The financing included an additional term loan of $400,000 and an increase in the operating line of credit from $2,300,000 to $2,800,000. The interest rate on the current bank indebtedness is at 3/4% above the prime rate. The operating loan and all term loans are secured by floating charge debentures issued by the parent company and certain subsidiary companies. The company has agreed to maintain working capital of $400,000 which is defined so as to exclude debt incurred on the purchase of businesses that is more than ninety days from maturity.

(c) Purchase of shares
On December 10, 1975, through an offer made to all shareholders, the company purchased for cancellation 400,772 of its own common shares at $2.20 per share. The company also purchased for cancellation 81,447 common shares of a former director and employee at a price of $2.00 per share. The net effect of these transactions was to reduce the outstanding number of common shares to 1,669,533 and the authorized number of common shares to 3,267,781.

Six Year Financial Summary 1970-1975

	1975	1974	1973	1972	1971	1970
		Years ended October 31, (THOUSANDS)				
STATEMENT OF INCOME						
Gross revenues	20,158	15,753	10,428	7,203	5,335	2,332
Income (loss) before extraordinary item	1,006	805	667	337	143	(652)
Net income (loss) for the year	1,006	403	586	624	351	(1,072)
BALANCE SHEET						
Working capital	1,603	1,229	1,134	687	113	(205)
Fixed assets (net)	2,139	1,728	977	750	567	574
Other assets (including goodwill)	3,646	3,618	3,703	3,122	2,749	2,561
Total assets	11,469	9,769	7,471	6,117	4,353	3,833
Long term debt	1,702	1,846	1,544	892	1,485	1,682
Shareholders' equity	5,616	4,621	4,234	3,667	1,944	1,248
SOURCE OF FUNDS (selected items)						
Working capital from operations	1,321	1,090	819	454	228	(540)
Issue of common shares	6	1	66	1,000	—	—
Issue of preference shares	—	—	—	—	275	—
Issue of long term debt	—	425	700	—	—	799
APPLICATION OF FUNDS (selected items)						
Purchase of fixed assets	854	987	380	297	164	481
Investment in subsidiaries and divisions	—	351	335	140	4	460
Dividends on preference shares	17	17	19	22	—	—
Reduction of long term debt	144	204	248	603	203	18
PER COMMON SHARE ($ per share)						
Earnings (loss) before extraordinary item	.46	.37	.31	.16	.07	(.35)
Earnings (loss) after extraordinary item	.46	.18	.27	.30	.19	(.57)
Number of shares outstanding at end of period (000's)						
Preference	42	42	42	55	55	—
Common	2,152	2,147	2,146	2,107	1,888	1,877

Directors and Officers

Directors:

†W. G. LEWITT	President, MDS Health Group Limited
R. H. YAMADA	Vice-President, MDS Health Group Limited
°DR. WILLIAM ANDERSON	Pathologist, Toronto General Hospital
°DR. J. C. NIXON	Medical Director, MDS Laboratories Limited
†*A. GRIEVE	President, Gdn. Ventures Limited
†*J. W. L. FORDHAM	Vice-President, Diamond Shamrock Corporation
R. D. WILSON, Q.C.	Partner, Fasken and Calvin
*R. HORNER	Investment Consultant
R. M. WARREN	Chief General Manager, Toronto Transit Commission

Corporate Officers:

W. G. LEWITT	President
R. H. YAMADA	Vice-President, Operations
D. M. PHILLIPS	Vice-President, Finance
J. E. BOYCE	Vice-President, Personnel
J. A. ROGERS	Secretary-Treasurer

E. K. RYGIEL	President, MDS Professional Services Limited

Head Office:	30 Meridian Road, Rexdale, Ontario M9W 4Z9 (416) 677-7661
Transfer Agents & Registrar:	Guaranty Trust Company of Canada, Toronto-Montreal
Auditors:	Clarkson, Gordon & Co.
Legal Counsel:	Fasken & Calvin
Stock Listing:	Toronto Stock Exchange, Montreal Stock Exchange, Symbol-MHG
Bankers:	Canadian Imperial Bank of Commerce

†Executive Committee **Audit Committee* *°Medical Advisory Committee*

Annual Meeting

The annual meeting of the Company's shareholders will be held on Thursday, March 4, 1976 at 4:00 p.m. at the Royal York Hotel, Toronto, Ontario.